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JOHN F. DAVIS,

IN THE

Supreme Court of the United States

October Term, 1967

No. 831

THE NEW YORK, NEW HAVEN and HARTFORD RAILROAD COMPANY FIRST MORTGAGE 4% BONDHOLDERS COMMITTEE,

Appellant.

against

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION, *et al.*,

Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY OF APPELLANT NEW YORK, NEW HAVEN AND HARTFORD RAILROAD COMPANY FIRST MORTGAGE 4% BONDHOLDERS COMMITTEE TO MOTIONS TO AFFIRM

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INDEX

Table of Cases

	PAGE
Baltimore & Ohio R. R. Co. v. *United States*, 386 U.S. 372 (1967)	2
Chase Manhattan Bank v. *Smith*, 378 F. 2d 635 (2d Cir. 1967)	9, 10
New York Central R. Co. v. *New York, New Haven & Hartford R. Co.*, 13 A.D. 2d 309, 216 N.Y.S. 2d 928 (1st Dept. 1961), aff'd, 11 N.Y. 2d 1077, 184 N.E. 2d 194 (1962)	11
St. Joe Paper Co. v. *Atlantic Coast Line R. Co.*, 347 U.S. 298 (1954)	7, 8, 9, 11

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The motions to affirm are dependent upon the Commission's recent November 16, 1967 Report (served November 21, 1967).* The issuance of that Report, at this time, requires an analysis of the Commission's past actions regarding the New Haven.

The Commission has, from the start, miscalculated its powers and confused the issues by erroneous assumptions

* It is understood that copies of the Report and accompanying orders have been furnished to the Court by Counsel for the Commission.

with respect to timetables and an absolute assurance, misplaced in fact, that it had the power to carry out a merger involving Penn-Central and the New Haven. The Commission's, Penn-Central's and the New Haven Trustees' assumptions as to the timetable of inclusion is described in the recent November 16 Report as follows:

> "Furthermore, when we approved the Penn-Central merger, anticipating that Penn-Central would enjoy some $80 million a year in merger savings, we were fully aware that the benefits would be diminished to the extent inclusion of the NH in the Penn-Central system was a negative financial factor. And, in this regard, language in our report, in the *NH Train Discontinuance* case, stating that 'there is no immediate likelihood of liquidation of the New Haven during 1966 or the next few months thereafter' (327 I.C.C. at 173), indicates that *we hoped and expected that Penn-Central would be taking over the NH's operations by this time.* On their part, it appears from the record that *Penn and Central anticipated,* when they reached agreement with the NH Trustees on the terms of the purchase agreement, *that the NH would be in their system by January 1, 1968*". (November 16 Report, slip opinion, p. 102) (emphasis added)

Those assumptions as to time have been frustrated, not by any action of New Haven creditors or security holders, but by events involving the misapplication of the Commission's powers with respect to other railroads. *Baltimore & Ohio R.R. Co.* v. *United States,* 386 U.S. 372 (1967).

In the first instance, the Commission had before it the application of the New Haven for the discontinuance of its passenger service. 327 I.C.C. 151 (1966). Had that application been treated on its merits, the discontinuance of the passenger service would have been granted, leaving the New Haven substantially a freight-only railroad. Such New Haven freight service would have been destroyed by the Penn-Central merger. Desiring the Penn-Central merger, the Commission did two things; it authorized the Penn-

Central merger and it denied the discontinuance application. This and this alone has (a) made it impossible for the New Haven to be reorganized in any other way than through a merger with Penn-Central; and (b) imposed continuing losses upon the New Haven, all of which have been borne by the New Haven creditors, and none of which have been borne by Penn or Central to this date. It is because the Commission foreclosed any other possibility of reorganization of the New Haven except through its inclusion in Penn-Central, that the New Haven now has no alternatives but inclusion in Penn-Central or the dismissal of the reorganization proceedings.

Error and miscalculation have now been "rescued" only by the compounding of errors. When the Commission denied the discontinuance applications of the New Haven it did so on the theory that the New Haven would soon be included in Penn-Central, 327 I.C.C. at page 173. Since the New Haven was not soon included in Penn-Central, it became necessary, from the Commission's point of view, forcibly to remove all obstacles to the inclusion although to this point of time the New Haven bondholders have not been the cause of the delay of the Penn-Central merger. The Commission has now determined to make it impossible for the bondholders to avail themselves of the halls of justice by imposing upon them such continuous losses that they will not be able to pursue their remedies in the courts. It is the New Haven bondholders that are being made to pay for the Commission's lack of foresight and its arrogation of powers never granted to it by statute.

By failing to require immediate inclusion and by limiting Penn-Central's participaion in the losses, but requiring the continuance of service, the Commission has imposed upon the New Haven bondholders the substantial losses of the next few years. By reducing Penn-Central's participation in the New Haven's losses with each passing year, (November 16 Report, slip opinion, pp. 105-106), while the

losses mushroom from year to year, it is apparent that the whole scheme of the Commission is to disable the creditors from pursuing their remedies.

The argument of Penn-Central that the inclusion of the New Haven was not at the heart of the Commission finding that the inclusion of all of the New Haven's operations in Penn-Central was the public interest justification for the Penn-Central merger is specious and circular. (Penn-Central Motion, pp. 12-14). The determination to include the New Haven passenger operations as well as freight operations in Penn-Central was simultaneous with the denial of the New Haven's discontinuance applications. The Commission could have granted the New Haven discontinuance applications, making possible the reorganization of the New Haven as a freight-only railroad. That would have offered to the New Haven a variety of rescue routes one of which at least would have been a possible merger with Penn-Central. If, however, the passenger service was discontinued, then the Penn-Central merger could not go forward, for that merger would have destroyed the New Haven's freight service. At that point at least, the New Haven was in the position of E-L, D&H and B&M when they were before this Court last year. The Commission desired to proceed with the Penn-Central merger. It therefore denied the New Haven any alternative means of survival except inclusion in Penn-Central and then it found that the Penn-Central merger was in the public interest because it saved all of the New Haven operations. That is the history. That the Commission and Penn-Central rewrite that history from time to time as to themselves convenient, is apparent. Penn-Central therefore argues, quoting the Commission, that the New Haven is almost dead and therefore is not entitled to indemnification or protection against diversion (Penn-Central Motion, p. 14). Had the Commission not concluded to force the New Haven into Penn-Central, passenger and freight together, "near death" would not be the situation of the New Haven today.

Penn-Central argues that the fact that the Commission could not have contemplated that any failure of inclusion by reason of action of New Haven security holders would have been permitted to frustrate the Penn-Central merger is evident from the fact that it authorized consummation of the merger although recognizing that inclusion would be subsequent to appropriate proceedings under the Bankruptcy Act (Penn-Central Motion, p. 13). The Commission, however, has argued that New Haven's protection against the Penn-Central merger rests on the fact that it has provided for inclusion. That is a significant part of the Commission's and Penn-Central's argument. How can it then be argued that the Commission, which justifies the approval of the Penn-Central merger and its consummation on the ground that the New Haven is protected, also rests part of its case on the ground that the merger should go ahead whether or not New Haven is protected?

It is not now and it never has been in the public interest for Penn-Central to merge if that merger involved the destruction of New Haven's railroad service. The continuance of the passenger service at the present level has brought the New Haven to its present crisis. The continuance of the passenger service at the present levels was justified by the Commission on the ground that Penn-Central would absorb the New Haven and soon. Yet now Penn-Central argues that it is in the public interest for the merger to go ahead whether or not the New Haven may be included and after other avenues of reorganization have been closed. It cannot be denied that the Commission intended that an essential benefit to be gained by permitting the merger of the New Haven's largest ally (Penn) with the New Haven's largest competitor (Central), was the preservation of the New Haven's services. This is made clear by the Commission in its recent November 16 Report as follows:

> "The Penn-Central merger (which will bring substantial dollar savings to the merger applicants)

> was approved with the thought that some of the merger savings would be available specifically to ward off a liquidation and shutdown of the NH so that adequate transportation service would remain available to the public which now relies on the NH." (November 16 Report, slip opinion, p. 63.)

If inclusion does not take place, those merger savings which the Commission intended to be used to "ward off" liquidation of the New Haven, will simply go into Penn-Central's pocket.

Is there any doubt that if this Court made it plain that the merger could not go ahead until by lease or otherwise the incubus of losses was lifted from the shoulders of the New Haven bondholders, that a lease containing such provisions would be entered into speedily by Penn-Central? Is there any doubt that the New Haven bondholders would support such a lease even that it gave to Penn-Central the right to petition for the discontinuance of certain unprofitable traffic? Thereafter, there would be left to be litigated only the question of whether the valuation and the consideration proposed by the Commission was fair and equitable and whether it was equitably distributed. None of this would affect the burden Penn-Central assumes nor the savings Penn-Central can make in the merger.

The Commission had already indicated that it never intended for Penn-Central to have to bear the losses to the extent the New Haven bondholders were expected to bear them. In its opinion approving the Penn-Central merger and requiring the inclusion of the New Haven in the merged system, it made plain that if Penn-Central asked for a discontinuance so that its burdens would be reduced, it would grant such a discontinuance unless the states or other authorities came forward with the necessary assistance so that

the merger savings of the Penn-Central would be left intact for the benefit of the public and the strength of the merged system.* The reason that the bondholders were required to carry these excessive losses was because the Commission found it easiest to cast the burden upon the weakest. What the Commission promised Penn-Central, it could have easily effected for the benefit of the New Haven. It did not do this, because the New Haven bondholders did not represent a group sufficiently powerful to bring the Commission into conflict with the local governments involved. In the first passenger discontinuance case, the Commission could have made precisely the same finding it warns the states it will make when Penn-Central applied. The losses therefore, even under a lease arrangement, need not continue at the level they presently stand at for the New Haven creditors. They can be reduced by the Commission's granting the relief to Penn-Central as leasee, that the Commission is prepared to grant Penn-Central as owner of the merged railroad.

The Commission, as we have shown, has counted on its power to include the New Haven in Penn-Central whether the security holders were for or against such a plan. It was this that brought the events we have described in its wake. But the Commission never had the power to compel such a merger. *St. Joe Paper Co.* v. *Atlantic Coast Line R. Co.*, 347 U.S. 298 (1954).

Despite the attempt of Penn-Central to slant the issue, the case of *St. Joe Paper Co.* v. *Atlantic Coast Line R. Co., supra*, has nothing to do with liquidation. It does, however, have much to do with the question of whether there is a reasonable certainty of inclusion of the New Haven in the Penn-Central system. The District Court believed that inclusion might be prevented unless this Court chose

*At 327 I.C.C. 526, the Commission stated: "Thus, the inclusion of New Haven's passenger service shall in no way be applied or construed to mean that New Haven passenger deficit operations, if undue, must be borne by the savings resulting from this merger."

to follow the dissenting views of Justice Douglas (B&O J.S., B-24). In light of the Commission's November 16 Report, however, the situation is now one that cannot be supported by *either the dissent or the majority opinion in the St. Joe Paper Case.* The November 16 Report provides for the transfer of the New Haven assets to Penn-Central, in return for an "economic equivalent" *without* the submission of the proposal to a vote of the first mortgage bondholders of the railroad (November 16 Report, slip opinion, pp. 113-114, 116).

The plan of reorganization in the *St. Joe Paper Co. Case* had as its basic element, the transfer of assets of the Florida East Coast Railway (a debtor in reorganization under Section 77 of the Bankruptcy Act), to the Atlantic Coast Line Railroad in return for the distribution of cash and various types of Atlantic Coast Line securities to Florida East Coast's bondholders. The bondholders (the largest of which was St. Joe Paper Co.), who had been recognized as "in substance the owners of the debtor railroad" (347 U.S. at p. 301), objected to the plan. Justice Frankfurter's majority opinion struck down the plan and concluded:

> "We therefore conclude that the Commission does not have under Section 77 of the Bankruptcy Act a power which Congress has repeatedly denied it under the Interstate Commerce Act, namely to initiate the merger or consolidation of two railroads." (347 U.S. at p. 306)
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> * * *
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> "The crucial question, therefore, is whether this merger plan meets the statutory requirements. Since it does not, as we have found, because it is sought to be imposed by Commission fiat rather than proposed by the merging carriers, it matters not that the security holders might ultimately accept it if it were put to them for a formal vote. The kind of Hobson's choice, more or less, to which security holders are put when voting on a merger plan is not to be put to them on a plan initiated by the Commission rather than by their own corporation." (347 U.S. at pp. 313-14)

Justice Douglas' dissenting opinion put the issue thusly:

> "The one and only issue before us at the present time is whether the Commission may include in a plan of reorganization a provision that the debtor or bankrupt railroad should be merged with another road and *submit that plan for approval or disapproval to the security holders who are entitled to vote on a plan.*" (347 U.S. at p. 322) (emphasis added)
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> "So far as this record shows, the Commission has faithfully, painstakingly, and conscientiously performed the obligations which § 5 of the Interstate Commerce Act imposes on it. It would seem obvious, therefore, that the Commission should be allowed to submit the plan, including the provision for a merger, to the security holders for their approval or disapproval." (347 U.S. at pp. 327-8)

The Commission's plan as enunciated in the November 16 Report, reverts back to a procedure which had been abandoned by the New Haven Trustees after adverse warnings issued by the Second Circuit Court of Appeals in *Chase Manhattan Bank* v. *Smith,* 378 F. 2d 635 (2d Cir. 1967). According to the Commission's plan, the New Haven's assets will be transferred to Penn-Central for various securities considered by the Commission to be an "economic equivalent", *without a vote of any security holders.* Such a procedure is flatly contrary to both the majority and the dissenting opinions in the *St. Joe Paper Co. Case.*

To ignore the fact that inclusion of the New Haven into Penn-Central as proposed by the Commission is in violation of the principles enunciated by the opinions of this Court in the *St. Joe Paper Co. Case,* is to ignore reality. While no challenge to the November 16 Report has been filed to date, the Committee intends to promptly institute proceedings before a statutory District Court and the

Committee has been informed that all of the creditors and creditor representatives who have been most active in these proceedings also intend to so proceed.

While the Commission has issued its November 16 Report on the eve of the argument in this appeal in an attempt to divert the impact of arguments presented by the New Haven bondholders, a reading of that report shows that there is no likelihood of it being sustained in the courts. Not only does it completely disregard the *St. Joe Paper Co. Case, supra,* but its valuations and legal reasoning are woefully inadequate. The differences between the Commission's findings and the bondholders' claims are so substantial, that if the bondholders have even partial success on judicial review, the feasibility of inclusion will be open to serious question. The following two brief examples illustrate the nature and magnitude of some of the issues:

1. Value of the consideration.—The Commission has found that the shares of Penn common stock to be paid to the New Haven for its assets have a value of $87.50 per share (slip opinion, p. 65). That value is used despite the Commission's finding, four pages later, that the common stock is to be valued at "market value at the time of issuance" (slip opinion, p. 69). On November 21, 1967, the date of service of the Report, Penn common stock closed on the New York Stock Exchange at $54 7/8 per share (New York Times Stock Index, Nov. 22, 1967). Penn stock has not even sold as high as $75 in the past ten years. If, as the Commission concludes, the value of the shares is $87.50, the 950,000 shares to be used as part of the purchase price, is $83.1 million. If one were to use a market value of $55 per share, the value of the 950,000 shares is $52.25 million. As a result, this issue of law alone involves a difference of more than $30 million. If the Commission is found to be incorrect, the result may be significant enough to upset the feasibility of the inclusion.

2. Grand Central real estate.—As recognized by the Commission, this real estate was appraised at $230 million (slip opinion, p. 57). That appraisal was based upon a capitalization of the income from the properties and Penn-Central does not take issue with the appraisal. The Commission has found that the New Haven's interest in these properties is substantial, whether or not the New Haven continues to run passenger trains into Grand Central station (slip opinion, pp. 51-58). The New York State courts have referred to the New Haven's interest in these properties as that of a "partner". *New York Central R. Co.* v. *New York, N.H.&H.R. Co.*, 13 A.D. 2d 309, 216 N.Y.S. 2d 928 (1st Dept. 1961), *aff'd*, 11 N.Y. 2d 1077, 184 N.E. 2d 194 (1962). The Commission found that transfer of New York Central's interest in the properties requires New Haven participation and that transfer of New Haven's interest requires Central's participation (slip opinion, p. 57). The proposed sale of the New Haven assets to Penn-Central includes a sale of New Haven's interest in this real estate. Instead of finding that the New Haven's interest is worth half of the appraised value, $115 million, to Penn-Central, the Commission came up with a clearly arbitrary value of $13 million. That was arrived at by capitalizing 40% of a figure representing net profit after the expenses of Central and New Haven for the running of trains, thereby arriving at $20 million, and then finding that the value lies between that figure and a $5 million figure that Central had admitted that it would pay as "nuisance value" for New Haven's interest. Since the difference between those two figures is $15 million, the Commission "split the difference" and found a "value" of $13 million (slip opinion, p. 58). The question of law regarding the Grand Central real estate involves a difference of $102 million! If the Commission is found to be incorrect on this item, the result may be significant enough to upset the feasibility of the inclusion.

The above two examples, coupled with the issues raised by the *St. Joe Paper Co. Case, supra,* make it evident that

inclusion of the New Haven remains uncertain and that the Penn-Central merger should not be permitted to proceed.

The New Haven Trustees argue that the Penn-Central merger should be permitted to be consummated because the bondholders are free to litigate the amount of interim participation in operating losses and the amount of the consideration to be paid (NH Trustees' Motion, pp. 22-23). But the bondholders are not free to litigate and they are not free to vote in a meaningful way on a reorganization plan. Because a failure of inclusion resulting from litigation or from a negative vote by the bondholders would, in the face of the Penn-Central merger and the refusal to permit the discontinuance of passenger trains that is linked with that merger, result in all of the interim losses falling upon the bondholders, those alternatives are realistically being taken away from the bondholders.

Conclusion

The Court should deny the motions to affirm, take jurisdiction of the appeal, reverse the order of the District Court and remand with instructions to restrain consummation of the Penn-Central merger unless and until the risk of New Haven's operations are assumed by Penn-Central between the date of consummation of the merger and the completion of the New Haven's reorganization proceedings.

Respectfully submitted,

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